North Dakota Office of State Tax Commissioner

2001 Income tax update

News and developments for tax practitioners

Legislative edition

June 2001

A publication of the Income and Oil Taxes Division

Rick Clayburgh
Tax Commissioner

In this issue

New individual income tax system and forms are in the works for 2001

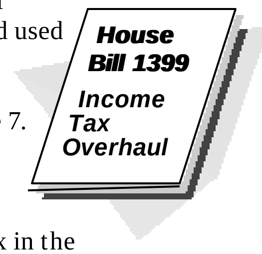
Its name, its look, and the system it represented are no more. Form 37-S, the short form, which has been the income tax form of choice for the vast majority of individuals for the past twenty years, will be replaced by a new form. The new form, named Form ND-1, will implement a new income tax system starting with 2001.

Created by the *Income Tax Revision Act of 2001* (House Bill 1399), the new system was put into place to prevent a state revenue shortfall that would result from the anticipated federal income tax rate cuts proposed by President Bush.

New tax rate structure

The former single tax rate of 14% has been replaced with a set of five rates—2.1%, 3.92%, 4.34%, 5.04%, and 5.54%. These rates are derived from multiplying each of the federal income tax rates that were in effect for the 2000 tax year—15%, 28%, 31%, 36%, and 39.6%—by fourteen percent. Each rate corresponds to one of five income brackets, and the income range in each of the brackets varies by filing status, i.e., single, married filing jointly, etc.

For 2001, the state income tax brackets will be identical to the 2000 federal income tax brackets as indexed for the 2001 tax year. For tax years after 2001, the state income tax brackets will be indexed for inflation using the same method used to index the federal income tax rates. The 2001 state income tax brackets are shown on page 7. Tax tables will be provided so that most individuals will not have to do any tax calculations, but will simply look up their tax in the applicable table.



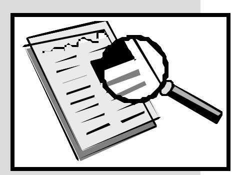
New calculation method

Under the new system, individuals will calculate a North Dakota taxable income to which to apply the new tax rates. The starting point in this calculation is federal taxable income. For most individuals, North Dakota taxable income will equal their federal taxable income, and all they will have to do is apply the applicable tax rate(s).

A number of individuals, though, will need to make one or more adjustments to federal taxable income to determine their North Dakota taxable income.

See **New income tax system** *on page 5*

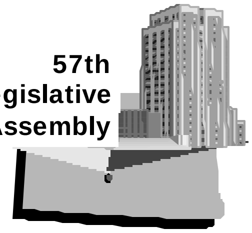
Highlights of new system for individuals



- **Starting point**—Changed from federal income tax liability to federal taxable income.
- **Tax rates**—Replaced 14% flat rate with five rates: 2.1%, 3.92%, 4.34%, 5.04%, and 5.54%. See page 7 for the 2001 tax brackets.
- **Farm income averaging method**—Created a 3-year income averaging method for eligible farm income that is similar to the federal method.
- **Capital gain exclusion**—Created a deduction equal to 30% of the excess of a net long-term capital gain over a short-term capital loss.
- **Credit for prior year minimum tax**—Created a credit equal to 14% of the eligible unused federal credit for prior year minimum tax. Expires after 2004 tax year.
- **Lump-sum distribution—**Created an addback adjustment for a lump-sum distribution for which the federal 10-year income averaging method was used.
- **Interest from out-of-state municipal bonds—**Treated the same: ***not*** taxable.

2001 legislative rundown

- **Summary of legislation affecting North Dakota income and financial institution taxes.**
- **To access any of these bills, go to: www.state.nd.us/lr.**



57th Legislative Assembly

HB 1063

Personal liability of LLC member

For income tax withholding purposes, if a limited liability company fails to file a withholding return or fails to pay the tax due on it, its members are personally liable for the failure.

Amended North Dakota Century Code (NDCC) § 57-38-60.2; effective for tax years beginning after 12/31/2000.

HB 1065

Partnerships

See the article on page 8 for a summary of the changes.

Amended subsections 4, 5, and 6 of NDCC § 57-38-04; amended § 57-38-08; created § 57-38-08.1; and repealed § 57-38-10; effective for tax years beginning after 12/31/2000.

HB 1072

Annual withholding return

The criteria that must be met to qualify to file an annual income tax withholding return were changed. If the total income tax withheld from wages paid during the preceding calendar year was less than $500 (formerly $250), an employer may qualify to file an annual withholding return for the current calendar year.

Note: This bill will not be fully implemented until 2002. However, if eligible, an employer may request to change to the annual filing basis for 2001.

Amended subsection 1 of NDCC § 57-38-60; effective for tax years beginning after 12/31/2000.

HB 1077

Time periods for filing and assessment

A new due date for filing was provided for a tax-exempt organization that is required to file a corporation income tax return (Form 40) to report unrelated business taxable income. The due date is the fifteenth day of the fifth month following the end of the tax year.

Amended NDCC § 57-38-34; effective for tax years beginning after 12/31/2000.

The time period in which a consent must be made to extend the time for the assessment of tax was expanded. A consent may now be entered into before the expiration of the six-year time period for assessment that applies in the case of an understatement of over 25% of taxable income or tax liability.

Amended subsection 8 of NDCC § 57-38-38; effective for tax years beginning after 12/31/2000.

HB 1078

Estimated individual income tax

The estimated income tax requirements for individuals, estates, and trusts were changed to provide that, if the net tax liability for the preceding tax year was less that $500 (formerly $200), there is no requirement to pay estimated tax for the current tax year.

Note: This bill will not be fully implemented until the 2002 tax year. However, a taxpayer currently paying estimated tax for 2001 may stop doing so if the new $500 threshold applies.

Amended subsections 1 and 3 of NDCC § 57-38-62; effective for tax years beginning after 12/31/2000.

HB 1223

Energy device credit

The provisions covering the geothermal, solar, or wind energy device income tax credit were changed as follows:

- The eligibility criteria were expanded to allow the credit for installing a device on property in North Dakota that
- The credit was changed to 3% of the cost of acquisition and installation, and is now allowed in each of the first 5 tax years, starting with the year in which the device is fully installed. (For devices fully installed before January 1, 2001, the credit remains at 5% in each of the first 3 tax years.)
- If a pass-through entity installs a device, the credit must be determined at the entity level and passed through to its owners in proportion to their ownership interests.
- The credit is not allowed for devices installed after December 31, 2010.

Amended NDCC § 57-38-01.8; effective for tax years beginning after 12/31/2000.

HB 1399

Individual income tax system

See the article starting on the front page for a summary of the bill's provisions.

Amended NDCC §§ 57-38-30.3 and 57-38-31.1; and repealed § 57-38-34.1; effective for tax years beginning after 12/31/2000.

HB 1413

Seed capital investment tax credit

See the article on page 4 for a summary of the changes.

Created a new subsection to NDCC § 57-38-30.3; amended subsection 4 of § 57-38.5-01; amended §§ 57-38.5-02, 57-38.5-03, and 57-38.5-05; effective for tax years beginning after 12/31/2001.

HB 1460

Renaissance fund corporation

A $2.5 million increase in the statewide ceiling on the total credits allowed for investments in renaissance fund corporations was authorized, subject to the following:

Income tax update is a publication of the Income and Oil Taxes Division, North Dakota Office of State Tax Commissioner, State Capitol, 600 East Boulevard Avenue, Bismarck, ND 58505-0599. It is published annually in October and after each legislative session in June. It is intended for tax professionals and other persons interested in developments, updates, and other information about North Dakota's income and financial institution tax laws, rules, and administrative policies. It is mailed free-of-charge to all persons on the Division's practitioners' mailing list. To get on the list, call (701) 328-3450 or toll free in North Dakota 1-800-638-2901; write to the above address; or go to our Web site at www.state.nd.us/taxdpt and click on Feedback.

- The increase is allowed only if the original $2.5 million ceiling (authorized in 1999) is reached.
- The additional $2.5 million of tax credits is only allowed for investments in a renaissance fund corporation that (1) has used over 65% of its net investments to provide financial assistance to qualifying zone projects or (2) was established *after* the original $2.5 million credit ceiling is reached.
- If triggered, the $2.5 million increase will be phased in according to the following schedule: $1 million will be allowed for investments made after December 31, 2000. The remaining $1.5 million will be allowed for investments made after December 31, 2002.

The bill also requires an annual audit of a renaissance zone corporation. The audit report must contain a statement of the percentage of annual net investments received after December 31, 2000, which have been used to provide financial assistance to zone projects. If an audit report shows that less than 50% of the aggregate net investments received during a renaissance fund corporation's previous four years of operation has been used to assist zone projects, it may not accept any new investments unless it can show good cause for the investment activity or until a subsequent audit report shows that the 50% level has been attained.

Amended NDCC § 40-63-07; effective for tax years beginning after 12/31/2000.

SB 2033

Renaissance zones

See the article on page 4 for a summary of the changes.

Amended NDCC §§ 40-63-01, 40-63-02, 40-63-03, 40-63-04, 40-63-05, 40-63-06, 40-63-07, 40-63-09, and 40-63-10; created a new section to ch. 40-63; and repealed § 40-63-08; effective 8/1/2001, except that the amendments to §§ 40-63-04 and 40-63-05 are effective for zone projects amendments to § 40-63-06 are effective for zone projects approved after 7/31/2001.

SB 2060

Multiple delinquency penalty

The multiple delinquency penalty of 10% (for 4 to 8 delinquencies) and 15% (for 9 or more delinquencies) that applies for income tax withholding and sales tax purposes was repealed.

Amended subsection 2 of NDCC § 57-38-45; effective 8/1/2001.

SB 2189

Mutual fund dividend deduction

A regulated investment company is allowed a deduction for dividends paid to its shareholders or to a fund of a regulated investment company for purposes of determining its North Dakota taxable income. The deduction is allowed only for dividends attributable to income that is subject to North Dakota income tax. A regulated investment company is not allowed to deduct any dividends received, as defined in Internal Revenue Code Sections 243 and 245.

Created a new subdivision to subsection 1 of NDCC § 57-38-01.3; effective for assessments of additional tax made after 12/31/2000.

SB 2252

Adoption deduction

The deduction currently allowed under the long-form method of filing for individuals for adopting a child under age 21 was increased from $1,000 to $1,750. A five-year carryover of any unused deduction was also added.

Note: The bill also would have allowed up to $1,750 of the federal adoption tax credit to offset the federal income tax liability under the short-form method of filing for individuals. However, this provision is ineffective due to the enactment of House Bill 1399.

Amended paragraph 5 of subdivision d of subsection 1 of NDCC § 57-38-01.2; and amended subsection 5 of § 57-38-30.3; effective for taxable years beginning after 12/31/2000.

SB 2386

Agricultural commodity facility investment tax credit

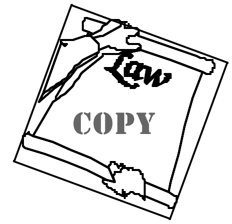
A new income tax credit is allowed to individuals, estates, and trusts for investing in a business that owns and operates an agricultural commodity processing facility in North Dakota. The business must be incorporated or organized in North Dakota after December 31, 2000, for the primary purpose of processing and marketing agricultural commodities capable of being raised in North Dakota. Producers of unprocessed agricultural commodities must own the majority of the business. The business must obtain certification from the North Dakota Department of Economic Development and Finance that it meets all of these conditions.

The tax credit is equal to 30% of the amount invested, subject to the following:

- Only the first $20,000 of investment is eligible.
- Only 50% of the credit is allowed in a tax year.
- The credit is limited to 50% of the tax liability.
- A 15-year carryover period is allowed for an unused credit.
- The investment must remain in the business for 3 years.
- If a partnership makes an investment, the credit must be determined at the partnership entity level and passed through to its partners—limited to individuals, estates, and trusts—in proportion to their respective interests.

Note: The credit is allowed on both of the individual income tax forms—Form ND-1 (formerly Form 37-S) and Form ND-2 (formerly Form 37).

Created a new subsection to NDCC § 57-38-30.3; and created ch. 57-38.6; effective for tax years beginning after 12/31/2000.



To obtain a copy of a bill, go to the Legislative Council's homepage at: **www.state.nd.us/lr**

North Dakota Renaissance Zones *Revisited*

Grand Forks and Bismarck become sixth and seventh cities with a zone

Renaissance zone benefits extended to rehab projects and existing lessees

Significant changes were made to North Dakota's renaissance zone law to clarify certain provisions and to enhance the tax benefits, especially for existing real property owners and lessees. The major provisions of Senate Bill 2033 are highlighted in this article.

The provision allowing a $10,000 income tax credit for purchasing a single-family residence was broadened to include a qualifying rehabilitation of a residence already owned by the individual. A qualifying rehabilitation means the cost of the rehabilitation equals or exceeds 20% of the residence's property tax valuation. The five-year credit period begins in the month the rehabilitation is completed.

The distinction between the business income exemption and the investment income exemption was removed to simplify the law. Now, the income exemption is allowed for purchasing or leasing residential or commercial property for either a business or investment purpose. In addition, the exemption was also extended to qualifying rehabilitations of residential or commercial property. A qualifying rehabilitation means the cost of the rehabilitation equals or exceeds 50% (20% in the case of a single-family residence) of the property's value for property tax purposes. The five-year exemption period begins in the month in which the rehabilitation is completed.

A new tax benefit was added which allows an individual who purchases or expands a business to elect to take an income tax credit of up to $2,000 in lieu of taking the income exclusion (for business use property) that would otherwise be allowed under the renaissance zone provisions. To qualify, at least $75,000 must be invested, the business must be located in a city with a population of no more than 2,500, and the election (which is not revocable for five years) must be part of the zone project application.

The amount allowed as a credit for investing in the preservation or renovation of historic property was changed to 25% of the amounts invested in all tax years, not to exceed $250,000. The first year in which the tax credit must be claimed was changed from the

See **Zone** *on page 5*

Definition of a qualifying lease expanded

The definition of a lease for purposes of the business and investment income exclusion under the Act was revised to include (1) a new business moving into the zone, (2) an existing business in the zone that leases additional space for an expansion, and (3) an existing tenant who continues a lease in a building in the zone that is the subject of a rehabilitation zone project.

$eed capital

Primary sector growth

Several limitations removed to breathe new life into seed capital investment law

The seed capital investment tax credit provisions in N.D.C.C. ch. 57-38.5 have been dormant since their creation in 1993. The 2001 legislature made a number of changes to them in an effort to stir up more interest in them.

The definition of a qualified business in which the investment must be made was changed to remove the requirement that the majority of ownership interests must be held by individuals who operate the business on a full-time basis. With respect to the requirement that the business must have its principal office or a significant operation in North Dakota, the significant operation qualifier was changed to lower the number of required employees from 25 to 10, and to lower the annual sales requirement from $250,000 to $150,000.

An additional feature was added to allow the credit for investments in an organization that builds and owns a value-added agricultural processing facility that it leases (with an option to purchase) to a qualified business.

The tax credit provisions were changed as follows:

- The credit is allowed on both of the individual income tax forms—Form ND-1 (formerly Form 37-S) and Form ND-2 (formerly Form 37).
- The provision limiting the credit to 50% of the tax liability was removed.
- The unused credit carryover period was reduced from 15 to 4 years.
- With respect to the ceiling on the total amount of tax credits allowed for investments in one qualified business, the limitations based on a percentage of the annual investments and on annual gross receipts from out-of-state sales were removed.
- The annual ceiling of $250,000 on credits for all investments was removed. It was replaced with a ceiling equal to $1 million for investments made through the 2002 calendar year, and $2.5 million for investments made after the 2002 calendar year.

Note: These changes are effective for tax years *after 2001*.

Created a new subsection to North Dakota Century Code § 57-38-30.3; amended subsection 4 of § 57-38.5-01; and amended §§ 57-38.5-02, 57-38.5-03, and 57-38.5-05; effective for tax years beginning after 12/31/2001.

New income tax system *continued from front page*

The following must be added to federal taxable income:

- Lump-sum distribution reported on Form 4972 (10-year averaging method).
- Loss from a pass-through entity subject to North Dakota's financial institution tax.

The following must be subtracted from federal taxable income:

- Interest from U.S. obligations (including dividends from a mutual fund which are attributable to similar investments by the fund).
- 30% of the excess of a net long-term capital gain over a net short-term capital loss.
- Native American's income which federal law exempts from state income tax.
- Retirement, unemployment, and sick pay benefit received from the U.S. Railroad Retirement Board.
- Income from a pass-through entity subject to North Dakota's financial institution tax.
- Income exempted under the Renaissance Zone Act.

The 30% exclusion for net long-term capital gains was adopted in lieu of special maximum long-term capital gain tax rates. For individuals with long-term capital gains, this feature is not revenue-neutral when compared to the old short-form system, and these individuals may see a higher or lower tax under the new system.

Similarly, the adjustment for a lump-sum distribution is not revenue-neutral to the individual. Under the new system, the distribution is taxed at the regular tax rates which will result in a higher state tax.

Farm income averaging

A 3-year income averaging method similar to the one used for federal income tax purposes was adopted. A new schedule, called Schedule ND-1FA, is being developed for this calculation. This method is available only under the new system implemented on Form ND-1.

Prior year minimum tax

A credit for any unused federal credit for prior year minimum tax was adopted for the 2001 through 2004 tax years. "Unused federal credit for prior year minimum tax" means any federal credit for prior year minimum tax remaining as of the beginning of the 2001 tax year which is attributable to federal alternative minimum tax reported on Form 37-S for tax years before 2001. The credit is equal to 14% of the unused federal credit for prior year minimum tax actually claimed on the taxpayer's federal income tax return for the tax year.

Nonresidents

Although the calculation of the tax for a nonresident of North Dakota will look different for manner. In general, the tax must be calculated on the nonresident's total income for the year, and then it is multiplied by the ratio equal to North Dakota adjusted gross income divided by federal adjusted gross income. A new schedule, Schedule ND-1NR, will replace both the Schedule NR and Adjustment Schedule for purposes of the new system.

Dual systems

The 2001 legislature did not change or remove what has been known as the long-form method on Form 37, so North Dakota still has two individual income tax systems. The new system now shares some characteristics of the long-form method—most notably, the federal taxable income starting point. However, the adjustments, credits and tax rates under each system are different, and the tax outcome will be different under each one. The majority of individuals will still calculate a lower tax under the new system.

To help distinguish between the two systems, the forms for the two systems will be placed in separate booklets for 2001. In addition, Form 37 will be renamed Form ND-2 and identified as the optional method. Moreover, the commonly used designations of "short form" and "long form" will be dropped to help prevent the misperception that one form is merely a shorter version of the other.

Illustration A

See **page 6** for structure of new system

Illustration B

See **page 7** for basic calculation/rates

Withholding changes?

For the 2001 calendar year, **NO** change will be made to the North Dakota income tax withholding calculation or the flat 14% withholding rate.

For the 2002 calendar year, however, changes to both the calculation method and the rate of withholding will be made because of the new income tax system created by House Bill 1399 and the recent changes made to federal income tax law.

Employers will be notified in separate mailings about what to do for 2001 and, more importantly, 2002.

Zone *continued from page 4*

year in which the investment is made to the tax year in which the preservation or renovation work is completed. In addition, the sunset date of December 31, 2004, was removed to allow qualifying investments to be made after 2004.

Changes were also made to the renaissance fund corporation provisions. The term "renaissance fund corporation" was changed to "renaissance fund organization" (RFO) to allow any type of entity to be used as the vehicle for raising funds to invest in zone projects. The use to which a particular RFO may put its funds was expanded to allow investments to be made in (1) projects throughout the state and (2) businesses which are not zone projects but are located in the zone of the city that established the RFO.

Last but not least, the property tax exemption provisions were expanded to allow the exemption for making a qualifying rehabilitation to real property. The definition of a qualifying rehabilitation is the same as that for the business and investment income exemption mentioned earlier in this article.

Also see the summaries for House Bill 1460 and Senate Bill 2386 on pages 2 and 3, respectively, for other changes affecting North Dakota's renaissance zone provisions.

More RZ stuff

Both the ND Division of Community Services and the ND Tax Department are revising their respective printed renaissance zone guidelines to reflect the 2001 legislation. The revised guidelines will be placed on each agency's Web site when they are available.

Illustration A

New individual income tax system: Overview of structure and basic components

Federal taxable income

plus or minus

Adjustments

Additions—Add the following to federal taxable income:

1 Lump-sum distribution from a qualified pension plan for which the federal 10-year averaging method was used.

2 Loss from a pass-through entity that is subject to ND's financial institution tax (under N.D.C.C. ch. 57-35.3).

Subtractions—Subtract the following from federal taxable income:

1 30% of a net long-term capital gain.[1]

2 Interest from U.S. obligations.

3 Exempt income of a Native American.

4 Benefits from the U.S. Railroad Retirement Board.

5 Income from a pass-through entity that is subject to ND's financial institution tax (under N.D.C.C. ch. 57-35.3).

6 Income exempted under ND's Renaissance Zone Act.

equals

ND taxable income

multiplied by

Tax rate

- **Tax tables**—There are five income tax brackets with the following rates: 2.1%, 3.92%, 4.34%, 5.04%, and 5.54%. The income ranges for each bracket differ depending on the taxpayer's federal filing status.[2]
- **Farm income averaging method**—A farmer may calculate the tax using a 3-year income averaging method.[3]
- **Nonresident**—After calculating the tax in the same manner as for a resident, multiply the resulting tax by the ratio equal to ND adjusted gross income divided by federal adjusted gross income.[4]

equals

Tax

minus

Credits

Credits—The following may be subtracted from the tax:

1 Credit for income tax paid to another state.

2 Family member care credit

3 Renaissance fund organization investment credit.

4 Renaissance zone historic property credit.

5 Renaissance zone single-family residence credit.

6 Seed capital investment credit. (New starting in 2002)

7 Agricultural commodity processing facility investment credit. (New for 2001)

8 Credit for unused federal credit for prior year minimum tax. (New for 2001)

equals

Net ND tax liability

1 A net long-term capital gain equals the excess of a net long-term capital gain over a net short-term capital loss.

2 The tax brackets for each filing status can be seen on page 7 of this newsletter. The brackets will be indexed starting in 2002 using an indexing method which is identical to the one currently used for federal income tax purposes.

3 Eligibility is based on the same eligibility criteria used for federal income tax purposes. A new supplemental schedule, Schedule ND-1FA, must be completed and attached to the return.

4 For this purpose, federal adjusted gross income must be reduced by interest from U.S. obligations before calculating the ratio.

Illustration B

New individual income tax system: Basic tax calculation for most taxpayers

1	**Federal taxable income** from federal income tax return	1	________
2	Additions—see **Note A**	2	________
3	Balance (*Add lines 1 and 2*)	3	________
4	Subtractions—see **Note B**	4	________
5	**North Dakota taxable income** (*Subtract line 4 from line 3*)	5	________
6	**Tax**—Use the tax rate schedule for the applicable filing status—see **Note C**	6	________

Single

If North Dakota taxable income is: Over	But not over	Your tax is equal to:				
$ 0	$ 27,050			2.1%	of North Dakota taxable income	
27,050	65,550	$ 568.05	+	3.92%	of the amount over	$ 27,050
65,550	136,750	2,077.25	+	4.34%	of the amount over	65,550
136,750	297,350	5,167.33	+	5.04%	of the amount over	136,750
297,350		13,261.57	+	5.54%	of the amount over	297,350

Married filing jointly or Qualifying widow(er)

If North Dakota taxable income is: Over	But not over	Your tax is equal to:				
$ 0	$ 45,200			2.1%	of North Dakota taxable income	
45,200	109,250	$ 949.20	+	3.92%	of the amount over	$ 45,200
109,250	166,500	3,459.96	+	4.34%	of the amount over	109,250
166,500	297,350	5,944.61	+	5.04%	of the amount over	166,500
297,350		12,539.45	+	5.54%	of the amount over	297,350

Head of household

If North Dakota taxable income is: Over	But not over	Your tax is equal to:				
$ 0	$ 36,250			2.1%	of North Dakota taxable income	
36,250	93,650	$ 761.25	+	3.92%	of the amount over	$ 36,250
93,650	151,650	3,011.33	+	4.34%	of the amount over	93,650
151,650	297,350	5,528.53	+	5.04%	of the amount over	151,650
297,350		12,871.81	+	5.54%	of the amount over	297,350

Married filing separately

If North Dakota taxable income is: Over	But not over	Your tax is equal to:				
$ 0	$ 22,600			2.1%	of North Dakota taxable income	
22,600	54,625	$ 474.60	+	3.92%	of the amount over	$ 22,600
54,625	83,250	1,729.98	+	4.34%	of the amount over	54,625
83,250	148,675	2,972.31	+	5.04%	of the amount over	83,250
148,675		6,269.73	+	5.54%	of the amount over	148,675

Note A—Additions to federal taxable income (*If applicable, enter on line 2 of worksheet.*)

- Amount of a lump-sum distribution from a pension plan for which the federal 10-year averaging method was used to calculate the federal income tax on the distribution.
- Loss from a partnership, S corporation, or other pass-through entity that is subject to North Dakota's financial institution tax.

Note B—Subtractions from federal taxable income (*If applicable, enter on line 4 of worksheet.*)

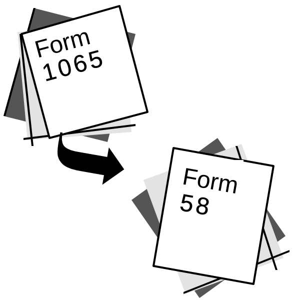
- 30% of the excess of a net long-term capital gain over a net short-term capital loss.
- Interest from U.S. obligations (including the portion of dividends from a mutual fund attributable to the fund's investment in U.S. obligations).
- Retirement, unemployment, and sick pay benefits received from the U.S. Railroad Retirement Board.
- Income of a Native American who lives and works on the reservation where enrolled as a member.
- Income from a partnership, S corporation, or other pass-through entity that is subject to North Dakota's financial institution tax.
- Income exempted under North Dakota's Renaissance Zone Act.

Note C—The following are not accounted for in the worksheet calculation.

- **3-year farm income averaging method.** A 3-year income averaging method for farm income that is similar to the one used for federal income tax purposes was adopted. The details of the calculation are pending development of a new schedule, Schedule ND-1FA.
- **Unused federal credit for prior year minimum tax.** A credit for unused federal credit for prior year minimum tax was adopted for the 2001 through 2004 tax years. "Unused federal credit for prior year minimum tax" means any federal credit for prior year minimum tax remaining as of the beginning of the 2001 tax year which is attributable to federal alternative minimum tax reported on Form 37-S for tax years before 2001. The credit is equal to 14% of the unused federal credit for prior year minimum tax actually claimed on the taxpayer's federal income tax return.
- **Nonresident calculation.** The tax for a nonresident is calculated in two steps: **Step 1**—Calculate the tax in the same manner as for a resident. Do not exclude any non-North Dakota income in this step. **Step 2**—Multiply the tax calculated in Step 1 by the following ratio: North Dakota adjusted gross income divided by federal adjusted gross income (as reduced by interest from U.S. obligations).

New treatment for certain guaranteed payments to nonresident partners

Partnership tax law changes affect certain nonresident individual partners



The 2001 North Dakota Legislature passed legislation clarifying the income tax treatment of partnerships and their individual partners. In particular, it makes the law more explicit on how the income of a multistate partnership is taxed to its nonresident individual partners.

The legislation, contained in House Bill 1065, was introduced at the request of the Tax Commissioner. Prompting the bill's introduction was an issue of interpretation of current law regarding the proper treatment of guaranteed payments to the nonresident individual partners of a multistate partnership.

Rather than litigate the issue, the Tax Commissioner chose to present the issue to the legislature for its consideration and decision on how the guaranteed payments should be treated for North Dakota income tax purposes.

General rule

In general, House Bill 1065 provides that guaranteed payments must be included in a multistate partnership's income that is subject to North Dakota's 3-factor apportionment formula. This follows the Tax Commissioner's interpretation and administration of the law as reflected on North Dakota Form 58, Partnership Return of Income.

Exception to general rule

The legislation creates an exception to the general rule for a professional service partnership (PSP). The exception provides that the portion of guaranteed payments constituting a reasonable salary to the partners (both resident and nonresident) is not included in the multistate partnership's income subject to apportionment. The portion of guaranteed payments constituting payment for items other than salary—such as interest on a loan, return on capital investment, etc.—remains in the partnership's income subject to apportionment.

With respect to guaranteed payments for salary that are removed from the partnership's apportionable income under the exception, the portion paid to nonresident partners is taxable and must be reported to North Dakota ***only to the extent it is for services performed in North Dakota***. The portion paid to residents of North Dakota remains taxable in North Dakota.

For purposes of the exception to the general rule, a "professional service partnership" means a partnership that engages in the practice of:

1. Law.
2. Accounting.
3. Medicine.
4. Any other profession in which neither the capital nor the services of employees are a material income-producing factor. This means the services of the partners themselves must be the primary income-producing factor.

A professional service partnership does not include one that primarily engages in wholesale or retail sales activity, oil and gas production activity, manufacturing activity, or other similar types of activities.

A partnership that does not fall into one of the above professional service partnership categories may apply in writing to the Tax Commissioner for permission to use the exception or to use an alternative method to the general rule. This permission applies only to the extent it affects the determination of the amount of income that a nonresident individual partner must report to North Dakota.

North Dakota Form 58, the partnership return, will be revised for the 2001 tax year to reflect these changes. These changes are effective for taxable years beginning after December 31, 2000.

Where to reach us. . .

Phone numbers

General toll free (*within North Dakota*)	1-800-638-2901
Individual income tax	701-328-3450
Income tax withholding	701-328-3125
Withholding toll free	1-877-638-2966
Corporation income tax	701-328-2046
Sales and special taxes *Includes sales, use, motor fuels, estate, city lodging, highway contract privilege, and music composition performing rights taxes.*	701-328-3470
Oil and gas taxes	701-328-2014
Property tax	701-328-3127
Commissioner's office	701-328-2770
Speech/hearing impaired	Call Relay ND at 1-800-366-6888 (*ask for 1-800-638-2901*)

Address
Office of State Tax Commissioner
State Capitol
600 East Boulevard Avenue
Bismarck, ND 58505-0599

Web site
www.ndtaxdepartment.com

E-mail
taxinfo@state.nd.us

Comments?
You may direct your comments on this publication to Joseph Becker.
Phone: 701-328-3451.
E-mail: jjbecker@state.nd.us.